



Investment Office

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AGENDA ITEM 7b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** External High Yield Manager Request for Proposal (RFP) - Fixed Income Non-Investment Grade Bonds and Leveraged Loans
- II. PROGRAM:** Global Fixed Income
- III. RECOMMENDATION:**
 - (1) Staff requests approval of a Request for Proposal for the establishment of a "Spring-Fed Pool" of Non-Investment Grade Bond and Leveraged Loan Managers.
 - (2) Approve the use of annual review contracts for the "Spring-Fed Pool" of Non-Investment Grade Bond and Leveraged Loan Managers.

IV. ANALYSIS:

Background

In March 2001, the Internally Managed Domestic Fixed Income portfolio was \$36 billion. At the March 2001 Investment Committee meeting, the Investment Committee approved an increase in the allowable allocation to non-investment grade corporate investments from 5% to 10% of Internally Managed Domestic Fixed Income and approved an RFP for fixed income non-investment grade active managers. Through the RFP, five managers were selected and funded in early 2002.

In June 2007, the Investment Committee approved increasing the allowable allocation to non-investment grade corporate investments in Global Fixed Income

from 10% to 15%. This will be reflected in the Dollar Denominated Fixed Income Program Policy.

As of October 31, 2007, Internally Managed Domestic Fixed Income had grown over 60% to \$59 billion. Non-investment grade corporate securities comprised 2% or \$1.2 billion of Internally Managed Domestic Fixed Income: \$592 million was internally managed and \$633 million was externally managed. The program has been reduced from five managers to three managers: two non-investment grade corporate bond managers and one leveraged loan manager.

Ending October 31, 2007, since inception, the program has produced an annualized return of 11.40% versus the benchmark of 9.59% has provided an annualized excess return of 1.81%.

Summary and Recommendations

The fixed income non-investment grade program has provided solid excess returns. The size of assets in Internally Managed Domestic Fixed Income has grown from \$36 billion in March 2001 to \$59 billion in October 2007 and the maximum percentage range for non-investment grade corporate investments has grown from 10% to 15% resulting in a potential increase of \$5 billion to the maximum allowable allocation. Simultaneously, since the last RFP in 2001, the number of external managers has decreased from five to three.

Due to this reduction in the number of managers and the higher possible allocation to non-investment grade corporate securities, staff believes that more external managers should be retained and requests approval of a Request for Proposal for the establishment of a "spring-fed pool" of active non-investment grade bond and leveraged loan managers. The current external managers will continue to provide services under their existing annual review contracts. Staff will solicit proposals from a wide range of managers in the search process to create a diverse assortment of management styles from which to choose when allocating additional funds to the program. Staff will make every effort to include emerging managers as a part of the effort to have a wide range of managers in the search process. The use of a "spring-fed pool" will allow staff to add managers as needed in the future.

Staff will use the following criteria for manager selection:

1. Use of a consistent, replicable investment strategy that can be expected to add value over a passive benchmark going forward.
2. Depth of investment staff and convincing strategy to retain top talent.
3. Competitive fee arrangements.
4. A Strategic Relationship that provides for training of CalPERS' credit research staff and access to portfolio managers.

Annual Review Contracts

Additionally, staff recommends the use of annual review contracts, which provide for an undefined duration. This would be consistent with the contracting procedure used for all other investment management contracts. This recommendation is necessary to fulfill CalPERS' fiduciary duties to its members because the use of annual review contracts is a more efficient use of CalPERS staff, Board time, and other resources. The award of contracts without a defined duration is allowed under Board Resolution 92-04B-4.

V. STRATEGIC PLAN:

External investment manager performance is monitored by staff and reported to the Investment Committee per CalPERS Strategic Plan, Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions and Goal IX: Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

The allocation to managers hired under this RFP will come from Global Fixed Income assets. The managers will charge a fee for services. Current staffing within Global Fixed Income is sufficient to complete this request for proposal. Onsite visits will require travel expense.

Staff is bringing this item to the Investment Committee in order to expand capacity within Global Fixed Income to allocate assets to the non-investment grade markets when market conditions are attractive for increased exposure to this sector.

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